

1 sales practices," what exactly does that mean?

2 A Well, that can be very broad. It can be really
3 anything besides looking at the financials, essentially.
4 Much of that would involve looking at the activity and
5 customer accounts, the supervision of the activity in those
6 accounts, the type of products that were being sold, the
7 appropriateness of those products.

8 Q Okay. Was the Stanford Group Company cooperative
9 in connection with his examination?

10 A I don't specifically recall except for from reading
11 the report. You know, we didn't feel like we could get any
12 information regarding the actual bank.

13 Q And how come you felt that way?

14 A The specifics as to why I felt that way, I --

15 Q Okay.

16 A -- I don't recall. I remember feeling that way,
17 but I don't remember why.

18 Q Okay. Were there any specific documents or
19 information that you were trying to get in the examination
20 that they were unable to get or that was refused?

21 A Is that mentioned in the report? I don't
22 specifically recall that.

23 Q Okay.

24 A Oh, well, we did want more information, I believe,
25 regarding the -- the money, the addition to capital. And I'm

1 sure you'll have discussion with (b)(6), (b)(7)c, and he could
2 probably -- he was down there talking with them. So he
3 reme- -- may remember the specifics, but we were really
4 concerned about this. And we didn't feel like we could get
5 the information regarding the origins of those funds.

6 Q Okay. And why were you unable to get that
7 information? The company wouldn't give it to you?

8 A I don't recall the specifics. I assume that's why
9 but --

10 Q Okay. Let me ask you some questions about the
11 specifics of this report --

12 A Okay.

13 Q -- Exhibit 2. So under "Findings, Possible
14 Misrepresentations, Rule 10b-5," it talks about the fact that
15 SIB pays a recurring annual 3.75 percent referral fee to
16 Stanford Group. And then there is a footnote that says
17 "During 1996, the referral fee was 5 percent."

18 And then the last line of Page 2 of Exhibit 2, it
19 says "SIB pays out in interest and referral fees between 11
20 percent and 13.5 percent annually."

21 Do you know for how long a period that this was
22 going on where they were paying out on these CD's between 11
23 percent and 13.75 percent annually?

24 A I don't recall. I do know the firm started a
25 business in 1995, so I assumed it was related from 1995 on

1 because --

2 Q Okay.

3 A -- that was my focus.

4 Q Okay. And it says in this report, again, on Page 2
5 of Exhibit 2, "SIB promotes its products as being safe and
6 secure." And then it references the brochure which talks
7 about investment-grade bonds, ensure safety of assets,
8 traditional safeguards, a conservative approach.

9 And then it says here, "Based on the amount of
10 interest rate and referral fees paid, SIB's statements
11 indicating these products to be safe appear to be
12 misrepresentations."

13 So was the conclusion of this examination that SIB
14 could not be paying out fees between 11 percent and 13.75
15 percent annually using such safe and secure investments?

16 A That's correct.

17 Q And so did you or (b)(6), (b)(7)c contemplate the
18 responsibility that SIB was not actually investing these
19 monies in these CD's but perhaps was engaged in some sort of
20 Ponzi scheme or other fraud?

21 A That's correct.

22 Q Okay. I mean, we -- do you have a sense at the
23 time of how unusual it was to have a CD with 11 percent to
24 13.75 percent of returns?

25 A I don't recall what returns were at 1997, but I do

1 recall thinking this was absolutely ludicrous.

2 Q Okay. And why -- why do you say it was ludicrous?

3 A Because legitimate CD's do not pay that much over
4 market.

5 Q Okay.

6 A And the legitimate CD's do not also pay continuing
7 ongoing referral fees and certainly not ones of this size and
8 volume. It was, in my mind, impossible that this was a CD.

9 Q Okay.

10 MR. (b)(6), (b)(7)c: Do you know what the market return
11 rate was at the point of comparison around that time?

12 THE WITNESS: No.

13 BY MR. KOTZ:

14 Q But you understood that these CD's that were paying
15 out between 11 percent and 13.75 percent was significantly
16 above market at that time?

17 A Yes. Well, this is interest and referral fees
18 together --

19 Q Right.

20 A -- meaning it would have to pay 11. Yes, I -- I
21 understood that to be, as I said, ludicrous, fantastical,
22 impossible.

23 Q Right. And isn't it the case that if they were
24 paying the customers between 11 percent and 13.75 percent,
25 they must have been generating more than that for them to

1 make money, right, so in fact that returns were at least a
2 few percent above 11 and 7 -- 13.75?

3 A Well, the interest rate -- again, when we use the
4 11 to 13.75, that's the interest rate plus referral fee to
5 the broker, correct. And then the bank itself would have to
6 make even more. You know, what are they -- I don't know what
7 a spread is for a bank; but if it was just even one percent,
8 now you're looking nearly 15 percent annually on a
9 conservative investment, which is -- I can't think of enough
10 words to describe how --

11 Q It's -- would you say it's impossible?

12 A Yeah.

13 Q And then there's another item if you look on Page 3
14 of Exhibit 2, it says "Item of interest, Addition to Capital.
15 During 1996, Stanford made a cash contribution of \$19 million
16 to Stanford Group. We are concerned that the cash
17 contribution may have come from funds invested by customers
18 at SIB."

19 This fact that there was this very large cash
20 contribution and that the cash contribution may have come
21 from funds invested by customers, was that a red flag, as
22 well?

23 A Yes. I assumed he was possibly stealing from
24 investors.

25 Q Okay. And that -- would that be a -- an attribute

1 of Enforcement to investigate this company for possible fraud
2 based on what you found in the examination?

3 A That's correct.

4 Q And that fraud would potentially include a Ponzi
5 scheme, but it wouldn't necessarily be limited to a Ponzi
6 scheme?

7 A That's correct.

8 Q Okay. Let me show you another document.

9 MR. KOTZ: I'm going to mark it as Exhibit 3.

10 (Exhibit Number 3 was marked
11 for identification.)

12 BY MR. KOTZ:

13 Q This is an Office of Compliance Inspection and
14 Examinations Super Tracking and Reporting Systems, STARS.
15 And it's a five page document. Do you recognize this
16 document, Exhibit 3?

17 A I have seen a document like this before.

18 Q Okay. Do you know what it is? It looks like some
19 kind of printout.

20 A Yes, just a printout giving some basic information
21 regarding particulars on the examination.

22 Q Okay. So what is the STARS system?

23 A It's just a system where we keep track of exams
24 that we started, when they were closed, a disposition, you
25 know, various different statistics that would want to keep

1 regarding each examination.

2 Q Okay. It looks like there's a -- just a mistake
3 there on the front page where it says "Afghanistan"?

4 A Yeah, there were -- there was a while where there
5 was a -- some kind of glitch in it. And if you -- and it
6 would just stick in Afghanistan. We had a number at the time
7 that did that. It was --

8 Q But it was --

9 A -- fantastical. We didn't -- we live in Texas. We
10 had no idea that we had be seated to Afghanistan.

11 Q Okay. So that was just a mistake; is that right?

12 A Yes.

13 Q Okay. All right. If you look at the last page,
14 Page 5 of this document, the STARS printout, Exhibit 3, it
15 says "Violations Description, possible misrepresentation,
16 possible Ponzi scheme." Do you see that?

17 A Yeah.

18 Q Do you know who would have put that in? Would that
19 have been you or (b)(6), (b)(7)c ?

20 A It probably wouldn't have been (b)(6), (b)(7)c . I don't --
21 I don't remember.

22 Q Okay. And it might have been you?

23 A It might have been me.

24 Q Okay. A question for you, if you look at the exam
25 report, which we marked as Exhibit 2, it talks about possible

1 A In discussions with Enforcement, they seemed to
2 believe that that was a concern and maybe limited our
3 interests.

4 Q Why was that?

5 A It was never clear to me.

6 Q So in your view, if there is a company of which the
7 SEC has jurisdiction, then they are engaged in fraud of
8 people outside the United States, that would still be
9 something that the SEC should look at?

10 A Absolutely. I -- I don't -- people may have tried
11 to explain it to me; but at the end, I -- I couldn't
12 understand, why would it matter; we have a U.S. broker-dealer
13 engaged in fraud.

14 Q We want to stop him from ripping everybody off,
15 even if they're not only ripping U.S. citizens, right?

16 A Absolutely.

17 Q Okay. And do you remember who -- who did you have
18 those conversations with?

19 A No. And that's why I've been crazy the last week
20 trying to remember the conversations. I do -- and I
21 explained to (b)(6), (b)(7)c, I go in and out. And so my
22 memory -- (b)(6), (b)(7)c, and this was sort
23 of one of the first big projects I worked on when I came back
24 after (b)(6), (b)(7)c. Not an excuse, but there's some things
25 I don't remember very well.

1 examination? We can give you the names of a couple of people
2 who worked on the investigation if that would help.

3 A I know that the people that worked on the
4 investigation, and I -- it's like this blankness in my mind.
5 I remember when it was closed and that discussion. I
6 remember multiple discussions with Mary Lou regarding the
7 fraud and the impossibility; but I don't recall talking about
8 this with (b)(6), (b)(7)c or (b)(6), (b)(7)c.

9 Q Okay. Let me ask you this. How quickly after the
10 exam ended was the matter referred; do you remember?

11 A It was referred immediately, but you'll see that
12 they didn't open anything for a long time. Mary Lou actually
13 retired in January of 1998. And I was a very young branch
14 chief that had virtually no experience managing people and
15 going through (b)(6), (b)(7)c, and I remember being very
16 scared that I was left alone to try to make this happen.

17 Q Okay.

18 A And after she left, I obviously kept pushing. I
19 just can't recall because it took a long time to get anybody
20 to open something. Was it March of '98 before they even
21 opened it?

22 Q I believe it was May. Let me ask you this. You
23 said it was referred immediately. So the examination start
24 date was August 25th, 1997. The letter that was sent out
25 with the deficiencies was September 25th, 1997. So when you

1 say immediately, during what time frame do you think it was
2 referred?

3 A Either at or before September 25th.

4 Q Okay. And so how does it work when you refer
5 something? What do you do, make a phone call, send a memo,
6 send an e-mail?

7 A I live through many different administrations here
8 in terms of how that's handled. I have --

9 Q How was it handled then in 1997?

10 A Yeah. You call the head of Enforcement and send
11 them over a report, go down there and talk to them about it,
12 sell it. If you can find an attorney that seemed interested,
13 that was usually the best way, to go get an attorney excited
14 about the case. And then you could go present it to the head
15 of Enforcement; and not only do we have this great case, we
16 have an attorney that wants to work it.

17 Q Uh-huh. And so do you remember about how it worked
18 with respect to the referral that took place either on or
19 before September 25th, 1997 of the Stanford exam findings?

20 A No.

21 Q Okay.

22 A I can tell you what I learned.

23 Q Okay.

24 A I learned about the process. This is my first one
25 after I became branch chief, and I learned that you can't

1 just send it over and periodically check or ask. I learned
2 you have to be a tiger.

3 Q Okay. But at that time frame, you at least
4 remember that you sent it over and periodically --

5 A They --

6 Q -- asked about it?

7 A They -- they had it. And I know that I was more
8 aggressive than periodically asking about it. I just -- I
9 mean, I do remember talking to (b)(6), (b)(7)(c); but I -- I
10 don't remember if it was about this case. I -- I just don't
11 have memory. I'm sorry.

12 Q That's okay. Do you remember what the reaction was
13 from the Enforcement folks? Initially you said you had to
14 kind of -- you were pushing it. So what was their -- what
15 was their pushback?

16 A Well, I remember the concerns being that they were
17 non-U.S. citizens. I remember -- I can't even tell you if I
18 remember them being concerned about it being a CD and them
19 calling it a CD. I don't recall that. The most significant
20 thing I remember at the time was it was a non-U.S. citizen.

21 Q And so that was the reason that some folks in the
22 Enforcement gave for not wanting to conduct an investigation
23 of the Stanford findings?

24 A Yes.

25 Q Okay.

1 A Mary Lou Felsman has excellent memory at this time,
2 so she'll be a lot more helpful with you --

3 Q Okay.

4 A -- on this.

5 Q Do you remember if there was any discussions about
6 the possibility that this was a Ponzi scheme with the folks
7 in Enforcement at that time?

8 A I don't recall the specifics. We all thought it
9 was a fraud. It didn't matter if it was a Ponzi scheme, was
10 it a money laundering scheme.

11 Q Now --

12 A It was a scheme.

13 Q All right.

14 A And there was just no question in our minds it was
15 a scheme, and there was nobody that we ever didn't express
16 our opinion like that to. Just the specifics, I --

17 Q And do you remember if anyone in Enforcement ever
18 expressed to you that they didn't think it was a fraud? Or
19 was it these -- these other considerations, like it didn't
20 affect U.S. citizens?

21 A It was always about other barriers. I don't recall
22 anybody saying it wasn't a fraud. Maybe -- I thought maybe I
23 was overly aggressive sometimes in my thought about it being
24 a fraud. Of course, that, I dismissed. But it was more
25 related to barriers. This was a -- seen as a fantastically